BEFORE THE
FEDERAL TRADE COMMISSION

COMMENTS REGARDING RETAIL ELECTRICITY COMPETITION	)	**Docket No. V010003**

COMMENTS OF SHELL ENERGY SERVICES CO., L.L.C. REGARDING RETAIL ELECTRICITY COMPETITION

Shell Energy Services Co., L.L.C. ("Shell Energy") is a retail marketer of natural gas and electric services to residential and small commercial customers in a number of states throughout the United States, including Georgia, Ohio, Pennsylvania and Texas. Shell Energy has been a leader in the restructuring and retail access efforts in these and other emerging retail markets. Shell Energy is actively considering entering additional retail markets in order to compete for sales of gas and/or electricity to residential and commercial customers.

Shell Energy welcomes the effort undertaken by the Federal Trade Commission ("Commission") to gather information about the regulatory approaches taken in different states in connection with retail electricity competition. Shell Energy presents its comments in order to focus the Commission's attention on some of the issues that are most critical to the success of retail competition. Rather than address the specific details of the regulatory structure in any single state, Shell Energy attempts to address issues that are common to the retail competition programs in all of the states in which Shell Energy either has participated or has become acquainted.

Shell Energy is available to assist the Commission regarding retail electric restructuring issues.

History and Overview

1. Why did the state implement retail electricity competition? What problems of the previous regulatory regime was it trying to solve?

Answer:

Most states that have adopted electric industry restructuring programs, including retail electricity competition, have done so in order to provide an environment in which competing suppliers can offer price reductions and service innovations to all classes of customers. In general, electric industry restructuring has been intended to replace a single, inflexible monopoly utility supplier with multiple suppliers that compete for market share by offering differentiated products.

Most states have recognized that although distribution service is a natural monopoly function that can be provided by a single entity, the generation and power sale function is a service that can be provided on a competitive basis by multiple service providers. In addition, most states have recognized that all suppliers and customers must have equal access to transmission facilities, and that transmission can be managed by an independent entity that is regulated by the Federal Energy Regulatory Commission ("FERC").

States have recognized the benefits associated with generation competition. As long as a single utility performs the generation and power sale function, there will be little incentive for innovation and no flexibility in the terms and conditions of power sale service. Retail electricity competition has introduced innovation and flexibility into the generation function.

2. What were the expected benefits of retail competition? Were price reductions expected in absolute terms or in relation to what price levels would be absent retail competition? Were the benefits of retail competition expected to be available to consumers in urban, suburban, and rural areas? Were the benefits expected to be available for residential, commercial, and industrial customers? Were the benefits expected to be comparable for each group of customers?

Answer:

The expected benefits of retail competition have included absolute as well as relative (compared against the incumbent utility) price reductions, service innovations, differentiated products, environmental benefits (*e.g.*, green power), and more accurate price signals to consumers through service unbundling and time-of-use metering. In some states, all customers were provided an equal opportunity, at the outset of the program, to participate in retail competition. In other states, the program was designed to allow larger commercial and industrial customers to participate in retail competition initially, and then to expand to include small commercial and residential customers. In most if not all states, however, the objective has been to extend the benefits of competition equally to all customers.

3. What factors or measures should the Commission examine in viewing the success of a state's retail electricity competition program? How should these measures be evaluated?

Answer:

Shell Energy believes that the best measures of the success of a state's retail electricity competition program are the extent of customer participation in the program, and the number of suppliers actively participating in the program. In order to sustain a vibrant and innovative program, multiple suppliers must compete for sales of power to all classes of customers. Moreover, the supply affiliate of the incumbent utility should not dominate the retail market. Similarly, customers from all classes should participate at a meaningful level. Active participation in the program by a broad cross-section of customers sends the signal that customers are benefiting from the competitive options that are being offered by alternative service providers.

4. What are the most successful and least successful elements in the state's retail competition program? Has the state taken steps to modify the least successful elements?

Answer:

The most successful features of state retail electric competition programs include:

- Market Support Generation Capacity ("Jump Start Capacity") -- Concept in Ohio where the incumbent utilities (*e.g.*, the FirstEnergy distribution companies) must provide a specific amount of generation at a fixed price to competitive suppliers serving residential and non-residential load in the utility's service area.

- Municipal/Governmental Aggregation Opt-out Methodology -- A method used in states such as Massachusetts and Ohio whereby a city or town automatically aggregates through local initiatives retail electricity customers into a buying group unless a customer "opt-outs" of that group, thus reducing customer sign-up costs and negotiating power with suppliers.
- Assignment -- Mechanisms to assign customers to competitive suppliers.
- Competitive Provider of Last Resort -- Procedures to allow suppliers to bid competitively to provide "default" or "provider of last resort" services currently provided by the incumbent utility.
- Correctly Set Retail "Shopping Credits" -- When a customer selects a retail electricity supplier other than the incumbent utility for retail generation service, customers should receive a retail "shopping credit" on their utility bill reflecting the utility's cost to provide that retail service. Customers should not receive a credit based on lower wholesale generation costs or otherwise pay twice for generation service. Shopping credits must reflect an unbundling of utility services and provide an incentive for customers to choose a competitive supplier.
- Exit the Merchant Function -- Requirement that incumbent utilities must exit the merchant function.
- Efficient Customer-Switching Procedures -- Consumers should be able to sign-up with a competitive supplier in the same manner as the sign-up for utility services. There should be no greater hassle factor or cost for selecting a competitive supplier.
- Uniform business rules.
- Reasonable Consumer Protection Provisions.
- Effective Customer Education Programs -- Customer education is very important both in terms of consumer protection and to assist consumers to make economic decisions in a potentially unfamiliar marketplace. However, a viable marketplace containing multiple suppliers and consumer access must also exist or else customer education will create customer expectations of vibrant competition that does not exist.

Some of the least successful features of state retail competition programs include the following:

- Failure to Utilize Stranded Benefits -- Stranded benefits (meaning windfalls to the utility from the restructuring process) have not been used to support or promote a competitive retail market.
- Use of Retail Rate Freeze -- Rate freezes (or rate caps) mask the actual cost of the incumbent utility's power supply and thereby discourage consumers from seeking alternatives. Competitive suppliers that buy power in the wholesale market reflecting market costs cannot compete with frozen retail rates capped through a regulatory process.
- Use of Wholesale-based Shopping Credits -- It is illogical that *retail* shopping credits (described above) have been set in many states based on the utility's cost of a block of wholesale power without any recognition of the utility's cost to convert wholesale power into a retail product (*e.g.*, without including a retail adder). Furthermore, often that wholesale rate is itself artificially low in order to

allow utilities to claim reduced value for generation and, therefore, greater stranded costs. This "wholesale-based" shopping credit model is particularly unfair to residential and small commercial customers with volatile usage during the day (*e.g.*, low load factors).

- Failure to Mitigate Generation Market Power.
- Failure to Mitigate Transmission Market Power.
- Utility as Default Provider -- Retaining the utility as the "default" supplier or the "provider of last resort."
- Lack of Uniform Business Rules
- Ineffective Customer Education Programs

Consumer Protection Issues

1. What efforts were made to educate consumers about retail competition? How was the success of these efforts measured? Were the programs successful? Who funded these efforts? Who implemented the programs?

Answer:

Customer education is essential to the successful implementation of competition. Without an effective customer education campaign, consumers are unlikely to enter the new marketplace due to their lack of comfort with and understanding of customer choice. In the absence of meaningful customer participation, there is likely to be a backlash against competitive marketing efforts, further disadvantaging alternative suppliers wishing to enter the marketplace. An effective customer education effort must provide customers with accurate, unbiased information. Furthermore, a customer education campaign only will be effective where there is a viable, truly competitive market -- one that attracts multiple suppliers and consumers -- designed based on sound economics.

State regulators should undertake the responsibility of developing a statewide customer education campaign, which includes engagement of a marketing/advertising consultant, well in advance of the implementation of the education effort and the market itself. Utilities should not be left with the assignment of educating consumers as the approach and messages are likely to be insufficient and possibly biased against retail competition.

In addition, when developing a statewide campaign, regulators should encourage a broad range of stakeholders to consult in the process of developing the messages that will assist customers in learning what they need to know to become excited and confident in their ability to successfully choose an alternative supplier.

Accordingly, any consumer education program should be carefully developed and coordinated by a coalition of consumer groups, alternate service providers, utilities and regulators. Consumer education can be achieved through a combination of print and media advertisement, utility bill stuffers and substantive media articles.

2. Do consumers have enough information to readily make informed choices among competing suppliers? Did the state coordinate its labeling requirements about the attributes of a supplier's product, if any, with neighboring states? Is there a need for federal assistance to provide standardized supplier labeling? If so, what would be the most useful federal role?

Answer:

It is critically important that consumers receive clear and consistent information about their energy supply options. In addition to consumer education efforts, discussed above, the state should consider various means of publicizing names, services and other pertinent information concerning alternate service providers. However, labeling has an undesired impact on consumers and the retail market stifling innovation while fostering confusion and opportunity for gaming by suppliers.

Shell Energy believes that several problems exist with labeling requirements. First, labeling creates a homogeneous market place among competitive suppliers stifling innovation. For example, certain competitive suppliers would offer "weatherized" or "weather-proof" bills that are based on a fixed annual price rather than a per kilowatt price. Such weatherized bills are not possible in states where labeling requirements exist. Second, labeling can be confusing to customers and misused by unscrupulous suppliers. Specifically, where supply portfolios must be disclosed, competitive suppliers purchasing out of power pools or exchange pools cannot guarantee the portfolio of power purchased out of such pools. Additionally, certain states' labeling requirements, are unduly burdensome on suppliers and result in confusing customer bills. Customers lose the economies of scale and potential savings from more centralized billing systems that cover several states if suppliers are forced to adjust to a balkanized system of state and local utility labeling requirements.

Shell Energy suggests that the purposes and effects of labeling should be reassessed in light of the practical implications of such requirements.

3. Have consumers complained about unauthorized switching of their accounts to alternative suppliers ("slamming") or the placement of unauthorized charges on their electric bills ("cramming")? Were rules adopted to prevent these practices? Has the state taken enforcement action under its new authority against slamming and cramming? Have these actions been effective to curb the alleged abuses? Is there a need for federal assistance with slamming and cramming issues? If so, what would be the most useful federal role?

Answer:

Consumer education and consumer protection rules (including supplier licensing) provide the best defense against unscrupulous supplier activities. All competing suppliers are negatively affected when a few suppliers engage in abusive tactics. On the other hand, as more fully

discussed below, most states already have in place sufficient consumer protection laws that can be applied against unscrupulous energy suppliers.

The legitimate effort to provide consumer protection should not lead to excessive regulation of energy suppliers. Instead, Shell Energy advocates that states take action against suppliers that violate rules by enforcing the rules already in place, rather than enact more rules and regulations of all suppliers. Increased regulation necessarily is more costly for consumers.

4. How did the state facilitate the ability of customers to switch to a new supplier? Have these efforts been successful? Does the state allow consumers to aggregate their electricity demand? If so, has aggregation enabled consumers to benefit from retail electricity competition? If not, why not?

Answer:

Customer enrollment and customer switching should be accomplished efficiently. This means that alternate service providers should have maximum flexibility to sign-up customers or switch customers through the use of electronic means, or through telephonic or written communications. At the very least, it should be no more burdensome to select a competitive supplier than to sign-up with the incumbent utility. If it is more difficult or more costly to sign up with a competitive supplier, than this is a barrier to entry and merely serves to maintain the monopoly franchise. In certain states, competitive suppliers are required to obtain a "wet" signature in order to sign up customers because of the belief that this process is the least susceptible to manipulation or fraud. However, the "wet" signature requirement is equally subject to potential manipulation as other means of registering or switching customers. Simply put, the customer switching process should be flexible enough to keep pace with technology innovations.

5. Has the state established licensing or certification requirements for new suppliers to provide electricity to customers? Why? Which licensing provisions are designed to protect consumers? How do they operate? Has the state taken enforcement action against unlicensed firms? Have these actions been effective to curb unlicensed activity? Have these requirements acted as an entry barrier for new suppliers?

Answer:

The terms and conditions for an energy supplier's participation in the market are an important component of the restructuring process. Terms or conditions that are unreasonable will make it that much more difficult for retail suppliers to enter the market. Registration requirements should not serve as barriers to entry, because these requirements reduce the potential for effective competition. Competitive suppliers will have to recover the costs of registration and licensing from customers; this will make it more difficult to attract customers from default service, especially if the default service provider is not subject to the same conditions or costs. Unreasonable licensing requirements also add risks, thereby causing competitors to avoid certain markets and thwarting the efficiency of markets that rely upon the pricing discipline of robust markets. Moreover, credit requirements -- whether set by the local

utility commission or by the utility -- must be fair and reasonable and not designed to exclude competitors. Foremost, a supplier with a good credit standing should not be required to post a significant credit. Furthermore, any credit requirement must be reasonably set in accord with industry standards. Unreasonable credit requirements, including the type of financial credit instrument and the amount of that financial credit, act as a barrier to entry by competitive suppliers. Letters of credit, bonds, and parental guarantees have associated costs, including negative implications on a supplier's books. The amount of financial credit must be set based on reasonable expectation to secure payments, not as a punitive measure.

Moreover, it is important that supplier-licensing requirements do not put competitive suppliers at a disadvantage relative to monopoly default suppliers. Once again, such actions only serve to reinforce the market power advantage of the incumbent, creating market failures among alternate energy suppliers and threatening to restore the entire market to the monopoly provider.

Finally, licensing should not be used as a tool to regulate new providers of services. To the extent that market barriers are created, unnecessary risks are imposed, and competitors are inflicted with prosecutorial approaches that deny them the due process rights enjoyed by other purveyors of products and services in competitive markets. Most states have laws addressing marketing abuse and unfair advertising practices. Under those statutes, competitors enjoy the protections available to them through the courts. These same protections are not typically available to unregulated entities under the supplier licensing and consumer protection rules that are advocated frequently by regulators who are used to dealing with regulated monopoly providers.

It is critical that adequate protections exist for the competitive supply market if it is to function efficiently and effectively. Competition serves as its own consumer protection. The protection that results from competition should not be ignored in favor of rigid regulatory procedures.

6. Did the state place any restrictions on the ability of a utility's unregulated affiliate(s) to use a similar name and/or logo as its parent utility, in order to avoid consumer confusion when the affiliate offered unregulated generation services? Why or why not? What has been the experience to date with the use of these restrictions? Are consumers knowledgeable about who their suppliers are?

Answer:

An extremely important part of retail electric competition is the requirement that regulated utilities and their unregulated affiliates and divisions, or other unregulated entities within the utility, remain separate legal entities and not simply functionally separate.

With regard to corporate structure, utilities and their affiliates should be separate corporate entities with separate books and records, office space, and equipment. In addition, a utility should not be allowed to engage in joint marketing with its affiliate. Cross-subsidization of an unregulated affiliate by a regulated company must also be prohibited. Accounting controls

to detect such cross-subsidization are essential if corporate separation, rather than divestiture, is adopted as the means for mitigating market power.

Corporate separation is only a first step to mitigating vertical market power, however. Enforceable codes of conduct are an essential co-component of this strategy, without which the strategy would fail. Enforceable codes of conduct govern the relationship between a regulated utility and its affiliates. The basic ingredients or principles of any code of conduct must, at a minimum, incorporate rules regarding non-discriminatory treatment, and information and disclosure requirements.

With regard to non-discrimination, a utility should treat its affiliates or the customers of its affiliates in a manner comparable to the way it treats other market participants. For example, if a utility offers its affiliates capacity, services, information or a discount, the utility should also be required to make such an offer to all other market participants simultaneously on a non-discriminatory basis. Furthermore, a utility should not provide leads or solicit business on behalf of its affiliates, nor give the appearance that the utility speaks for the affiliate.

Regarding information and disclosure, if a utility makes any non-public information available to its affiliates related to provision of competitive services or the operation of the market, the utility should make the same information available to all market participants simultaneously on a non-discriminatory basis.

7. Did the state place any restrictions on third-party or affiliate use of a utility's customer information (e.g., customer usage statistics, financial information, etc.)? What were the reasons for enacting the restrictions? What has been the effect of these restrictions on new marketing activity?

Answer:

See response to Question No. 6, above.

8. Has the state adopted any other measures intended to protect consumers (e.g., length of consumer contracts, automatic renewal provisions, etc.) as it implemented retail competition? What has been the effect of these measures?

Answer:

Shell Energy does not believe that state regulators should impose undue restrictions on the flexibility of contracts entered into between alternate energy suppliers and their customers. Flexibility with respect to pricing terms and length of contract allows customers to achieve price savings, price stability, and service innovation.

9. To what extent have suppliers engaged in advertising to sell their product(s)? Do some suppliers claim that their product is differentiated (e.g., that it has environmental benefits)? Has there been any enforcement or attempts to verify these advertising claims? Do any certification organizations, such as Green-e, operate in the state? Are they used by (or at least available to) a substantial portion of consumers?

Answer:

The decision of an alternate service provider to participate in the competitive retail market requires a significant commitment of capital. Suppliers will commit to advertising and promotion if they are confident that the state's regulatory structure will provide a fair opportunity for competition. As more suppliers participate in the competitive retail market, more suppliers will offer differentiated products, including green energy.

Retail Supply Issues

1. What difficulties have suppliers encountered in entering the market? What conditions/incentives attract suppliers to retail markets? Have suppliers exited the market after beginning to provide retail service? If so, why?

Answer:

The difficulties that suppliers have faced in entering specific markets relate directly to the structure that has been established in a state for retail competition. For example, where the incumbent utility is designated as the "provider of last resort," alternate suppliers have more difficulty encouraging customers to switch to a competitive alternative. If the utility's cost of power is not identified clearly on a bundled sales customer's bill, it is extremely difficult for an alternate supplier to offer a price that competes against the incumbent utility's price. When customers that purchase power from the incumbent utility are subject to a rate freeze, these customers do not experience the actual cost of power, which makes it virtually impossible to compete against the incumbent utility. Similarly, when the price of power in a competitive market is premised on a dynamic wholesale power price and a static retail price, the amount of headroom available for suppliers to compete can be reduced, stifling competition. Finally, the lack of uniform business rules and the costs associated with developing software and operations infrastructure is an extraordinary barrier to entry for competitive suppliers serving customers in a number of states.

There are other aspects of competitive retail markets that bar entry of competitive suppliers. As noted above, the "registration" process and the process of switching customers to an alternate supplier can be onerous. Competitive suppliers also can encounter difficulties when, and if, the incumbent utility and/or its affiliates enjoy preferential access to generation capacity, customer information or system operation information. Along the same lines, in certain states, incumbent utilities have existing rights to transmission capacity that survive competition. Such existing transmission rights limit the ability of competitive suppliers to access essential transmission capacity. Finally, competitive suppliers can also face serious barriers to entry when

the costs of specific utility services that can be provided on a competitive basis (such as billing and metering) are not properly "unbundled" from the distribution rates of the customers that select a competitive supply alternative.

On the other hand, suppliers are attracted to a retail market when the system is structured to foster competition. For example, when the incumbent utility is removed as the provider of last resort, all suppliers are able to compete on an equal basis for sales to end-use customers. And, when a shopping credit is devised as an incentive to encourage retail competition, customers understand that as a structural matter, they can reduce their costs by purchasing from a competing supplier.

A fully unbundled rate structure also provides incentives for alternate service providers to enter the market. If the utility's costs are fully unbundled in such a manner that a competing supplier can provide the combined services at a cost less than the incumbent utility, the service provider can offer meaningful cost savings and flexible service options to its customers.

See also the answer to question 2 below.

2. What are the customer acquisition costs and operational costs to service retail customers? How do acquisition and operational costs compare to profit margins for electric power generation services? Do retail margins affect entry? If so, how? Did the state harmonize the procedures suppliers use to attract and switch customers with other states' procedures, in order to reduce suppliers' costs?

Answer:

Depending upon the structure of the state's retail competition program and the extent of customer education undertaken by the state, customer acquisition costs can be substantial. In view of the multitude of services provided by an alternate supplier to a retail service customer, the combination of customer acquisition costs and customer service costs can render profit margins extremely slim or non-existent. It is for this reason that it is extremely important for utility costs to be fully unbundled from the rates of those customers that select a competing supplier.

The utility should not retain monopoly control over billing, metering and customer account services. A prohibition on allowing competitive suppliers to offer customer billing and metering services reduces the overall level of benefit they can offer to customers and makes it harder for competitive suppliers to break into the retail generation market.

Before these services can be procured efficiently by customers from alternative suppliers, the utility's customer charges for these services must first be unbundled from regulated service rates. This unbundling allows customers to choose the package of customer services they want from the utility or from competitive suppliers, paying only for the services that they choose. Utilities should be required to unbundle customer metering and billing services, as a minimum requirement.

As long as utilities control metering and other technologically relevant equipment, they eliminate the ability of competitors to offer innovative, efficient technologies into the market. These innovations present the potential to mitigate the risks associated with real-time balancing and scheduling of energy, and provide both customers and suppliers with the data that they require to make more efficient purchasing decisions.

Just as compelling is the argument for unbundling the costs associated with billing and providing customers and suppliers with opportunities to provide billing in a manner that is appropriate for the customer and the product. Further, the information provided on bills is competitively sensitive to the supplier and, in many cases, to the customer. Utility control of billing information reinforces the utility's existing market power, further entrenching the incumbent in the market.

A primary means of succeeding, as a competitive supplier is the ability to provide and promote superior customer care as well as reasonably priced power supplies. Unbundling the costs associated with these services, however, is an important factor in providing an economically efficient product. Unbundled pricing should also lead to a greater number of competitive billing options and products and, accordingly, a more efficient and innovative marketplace.

3. Have customers switched to new suppliers? Why or why not? Are there greater incentives for certain customer classes (i.e., industrial, commercial, residential) than for others to switch suppliers? Why or why not? Are penalties or different rates applied to customers that switch back to the supplier of last resort? Are there other measures to determine whether customers are actively considering switching suppliers? If so, do these indicators show different patterns than the switching rate data?

Answer:

More industrial and large commercial customers have switched to competitive suppliers than small commercial and residential customers. Simply, it is more costly, on a per customer basis, for suppliers to serve residential and small commercial customers than it is for suppliers to serve large commercial and industrial customers. For this reason, many suppliers target large customers exclusively, and accordingly, smaller customers tend to be underrepresented among those customers that select a competitive retail service provider.

Shell Energy, however, focuses its marketing efforts on residential and small commercial customers. As a result, Shell Energy is acutely aware of the need for full service unbundling and full cost unbundling in order to enable a supplier to compete efficiently and effectively for such customers. In order to succeed in the market for sales to small customers, a marketer must be able to provide, at a lower price, all of the customer service functions, including billing and metering, that otherwise would be provided by the utility. Unless the utility's costs are fully unbundled from a customer's rate, a marketer cannot compete against the utility's subsidized rate.

In addition, the price of power used to establish the shopping credits in many states, is based on the price of a block of wholesale power at a high load factor. Large customers benefit

from such a product because they typically have high load factors. However, small commercial and residential customers (i.e., full requirements customers) have low load factors. Therefore, when full requirements customers contracts are tied to a block wholesale power price, the headroom available for suppliers to compete for such customers is squeezed.

4. Have suppliers offered new types of products and services (e.g., time of day pricing, interruptible contracts, green power, etc.) in states where retail competition has been implemented? If so, describe the products and what customer response has been.

Answer:

Price competition is only one of many benefits offered by alternate suppliers in a competitive market environment. Product differentiation and service innovation are extremely important to the success of a competitive service provider. Some of the services that are offered include: green power; electronic time-of-use metering; electronic billing; "weatherized" or "weather-proof" bills; discounts on differentiated products and services; energy efficiency audits; and rebates.

5. What are the benefits or drawbacks of the different approaches to handling the supplier of last resort obligation[1] for customers who do not choose a new supplier (e.g., allow incumbent utility to retain the obligation to provide generation services to non-choosing customers, auction the obligation, or assign the obligation to nonutility parties)? What has been consumer reaction to these approaches? Is provider of last resort service necessary?

Answer:

The states must establish procedures through which the utility will exit the "supplier of last resort" role for retail customers. As long as the incumbent utility retains the function of supplier of last resort, large and small consumers will be disinclined to switch to an alternative service provider. And, as long as the incumbent utility remains as the supplier of last resort, the barrier to entry by competing suppliers will be too high. The utility must be replaced, therefore, by one or more qualified suppliers to provide supplier of last resort service.

There is no clearer exercise of vertical market power than to allow the incumbent monopoly to use its past as a bundled service provider to guarantee for its future role as an unregulated monopoly in the generation business and in the retail energy services business. When an incumbent utility is designated as the default supplier, it is given -- it does not win -- a large set of customers for its retail energy services business. Moreover, the incumbent utilities do not have to pay to acquire such customers. If the incumbent utility feels free to use its own

[1] "Supplier of last resort" obligation refers to a company's duty to provide generation services to customers who have not chosen a new supplier. This obligation may be retained by the incumbent utility, it may be auctioned to alternative suppliers, or customers may be assigned to new suppliers. Many states have combined this obligation with the default service obligation to serve customers whose chosen supplier has exited the market.

generation to serve these customers, then it simultaneously is given — it does not compete for — a large market share in the generation business as well.

The right to be the default provider is a valuable one. The utility will not have the usual advertising and other marketing costs associated with obtaining customers. Customers who do not affirmatively choose a retail energy provider will simply be given to the utility. Incumbent utilities that receive customers on this basis avoid significant marketing costs. In the end, such a practice creates an uneven playing field between the incumbent utilities and competitive suppliers. Thus, the state should, after the commencement of competition, assign those customers to all licensed marketers who are willing to serve the residential class.

Residential customers should be given an adequate opportunity to choose their own registered marketer; however, after expiration of a reasonable notice period, as set by the state, customers who do not affirmatively choose a registered marketer should be assigned a default provider in accordance with the allocation procedures adopted by the state. The notice to retail customers should be completely neutral as to the choice of a registered marketer, but it should explain that (i) the state has ordered the regulated utility to cease providing electric service to all retail consumers in order to open up the market to competition; (ii) the state has determined that competitive alternatives should reduce the overall costs of electric to retail customers without compromising the reliability of service; (iii) the customer will continue to receive uninterrupted service irrespective of whether or not it chooses a marketer, but that by failing to affirmatively choose a marketer, the state will randomly assign a default provider; (iv) a customer's failure to affirmatively choose a specific registered marketer shall be interpreted by the state as a decision to accept service from the default provider; and (v) the customer will have an opportunity to change its assigned default provider at any time on 30 days notice, if it so desires. After the deadline determined by the state for retail customers to choose a registered marketer has passed, all retail customers who have not affirmatively chosen a registered marketer would be assigned to licensed marketers who elected to become providers of last resort based on the marketer's share of the market.

Provider of last resort energy sales service is necessary as a transition measure in a restructured electric market. Until all customers have selected a competing energy service provider, there must continue to be one or more providers that sells energy to customers that do not otherwise make an affirmative choice. Eligibility standards should be established for marketers that seek to offer provider of last resort service. The supplier of last resort should not be the utility, however. Removing the utility from this role mitigates the utility's market power in the energy sales market.

Retail Pricing Issues

1. How is entry affected by the price for the provider of last resort service (for customers who do not choose) or for default service (for customer whose supplier exits the market)? How does the price for the provider of last resort or default service compare to prices offered by alternative suppliers? Is the price for provider of last resort service or default service capped? If so, for how long?

Answer:

The price charged by the provider of last resort should be a fully bundled price that includes all costs associated with providing power, including necessary transmission charges. If the generation charge in the basic generation rate is set too low, an improper price signal will be sent to customers. An unreasonably low price charged by the supplier of last resort will discourage alternate suppliers from entering the retail marketplace. Because all customers receive fully bundled, basic generation service the day before retail competition begins, an artificially low price for the supplier of last resort will send a signal which inappropriately induces customers to stay with the incumbent utility supplier, which in turn creates a barrier to entry. In this case, competition will not occur.

The charge for basic generation service must have the full retail cost of supply embedded within the generation component. The cost of power in the retail market is different from the cost of power in the wholesale market. The retail supplier incurs costs in certain areas that do not apply in the wholesale market, such as the costs of administration, scheduling, coordination and marketing. These costs must be included in the charge for generation embedded in the generation component of default service or competition will be thwarted.

Moreover, the cost of competitive generation should recognize that customer classes have different load factors that affect the ultimate price of providing power to such customers. As noted above, the cost of providing power to high load factor customers such as industrials is lower than the cost of providing power to low load factor customers, e.g., residential customers. Therefore, the price of power used in providing default service should not uniformly be based upon the block wholesale price of power.

If the incumbent utility continues to own and operate generation facilities, and if the utility continues to serve as the supplier of last resort, the cost items that are relevant to — and should be included in -- the retail generation rate are:

- The cost of procuring or generating energy (including differentiating between full requirements customers and block power customers);
- The cost of procuring or constructing generating capacity that satisfies utilities' installed capacity obligation;
- A reserve margin on capacity to meet the reliability requirements of the power pool;

- The cost of administering and managing the energy and capacity procurement process; and

- The cost of marketing and administering power sales in the retail market.

- The costs of customer account services allocable to the generation portion of the rate.

2. Has the state required retail rate reductions prior to the start of retail competition? What is the rationale for these reductions? How have state-mandated rate reductions prior to the start of retail competition affected retail competition?

Answer:

Shell Energy does not support artificial rate reductions that are created through the issuance of revenue bonds or through some other form of cost deferral. These rate reductions distort market signals and merely serve to delay ratepayer responsibility for utility costs. By distorting price signals, the state discourages retail competition and confuses those customers that otherwise would be encouraged to participate.

Shell Energy also believes that artificial rate reductions can serve to stifle demand response programs. When retail rates are reduced to artificially low frozen levels, retail customers receive no price signal to respond to high prices in the market. The current situation in California, where retail customers were insulated from high prices through a rate freeze demonstrates this point. Such a result is counterintuitive to the way that competitive markets operate.

3. Do any seasonal fluctuations in the price of wholesale generation cause some suppliers to enter the market only at certain times of the year? How have these suppliers fared?

Answer:

Seasonal fluctuations in wholesale prices present both a challenge and an opportunity for competing suppliers. Some suppliers offer a fixed or levelized price that provides price stability for retail customers. These suppliers, in turn, bear the risks associated with seasonal fluctuations in wholesale prices. Suppliers have the ability, of course, to hedge these risks in forward markets or through trades or exchanges.

Other suppliers may offer a price that is indexed to short-term wholesale prices, thereby reducing the risk to the supplier while increasing the risk to the customer. Some customers may prefer this approach.

4. How has the state addressed public benefit programs (e.g., universal service requirements, low income assistance, conservation education, etc.) as it has

implemented retail competition? Which of these programs are necessary as competition is introduced and why? Are public benefits available to all customers or are they restricted to customers of the supplier of last resort? How does this affect retail competition?

Answer:

Shell Energy believes that public benefit programs should be equally available to all customers, including both customers served by the supplier of last resort and customers that elect retail competition. Customers that are eligible for public benefit programs should be able to take advantage of these programs whether or not they choose retail competition. However, it is vitally important that the costs of public benefit programs be unbundled from all other cost components in a retail customer's bill.

Market Structure Issues

1. How has the development of Regional Transmission Organizations (RTOs) affected retail competition in the state?

Answer:

Shell Energy supports the establishment of independent RTOs to manage and operate the transmission grid. An independent RTO will ensure that all suppliers and users have equal access to the transmission grid. An independent RTO will avoid conflicts of interest between and among the owners of generation, transmission and distribution facilities. An independent RTO will ensure that transmission access decisions will be made in a non-discriminatory manner based upon operational considerations.

2. Did the state require the divestiture of generation assets (or impose other regulatory conditions on the use of these assets) when retail competition was introduced? To what extent was divestiture of generation assets a component of the state's handling of a utility's stranded costs? Was divestiture used to remedy a high concentration of generation assets serving the state? Was there appreciable voluntary divestiture of generation assets? Has the state examined whether there has been appreciable consolidation of ownership of generation serving the state since the start of retail competition?

Answer:

In order to mitigate market power, some states mandated the divestiture of generation assets by the incumbent utility to non-affiliated entities. Shell Energy supports actions to reduce generation market power, such as auctioning assets, affiliate rules of conduct, market monitoring, and utility divestiture of generation assets to non-affiliated entities.

However, Shell Energy believes that these market mitigation power efforts must effectively provide for a deep, liquid market capable of sustaining competition for the supply of energy. These market power mitigation efforts should not be a means by which utilities are able to cross-subsidize between regulated and unregulated affiliates at the parent level. Finally, in

conjunction with the such efforts, as noted above, Shell Energy supports removal of the utility from the role of supplier of last resort.

3. If a utility no longer owns generation assets to meet its obligations as the supplier of last resort or default service provider, what market mechanism (e.g., spot market purchases, buy back or output contracts, etc.) does it use to obtain generation services to fulfill these obligations? What share of a utility's load is obtained via the different mechanisms? How are these shares trending? Is the market mechanism transparent? Is it necessary to monitor these market mechanisms? Why or why not? If so, what should the monitor examine?

Answer:

As noted above, Shell Energy believes that at the same time the divests its generation assets, the utility should withdraw from the roles of default supplier and provider of last resort. Consumers will enjoy greater competitive options when generation assets are held by multiple suppliers, and when power supply service is offered by multiple providers.

4. Explain the state's role in overseeing operation of the transmission grid in the state and the extent to which public power or municipal power transmission systems are integrated into this effort. What is the relationship between the state's role and the Federal Energy Regulatory Commission's role in transmission system operation in the state?

Answer:

As noted in response to question #1 in this section, operation of the transmission grid should be vested exclusively with the RTO. As discussed above, operation by and through the RTO ensures that decisions are made on a consistent and non-discriminatory basis without the threat of conflicts of interest. Public power and municipal power transmission systems should be invited to join and participate in the RTO.

5. Do firms that have provider of last resort or default service obligations (formerly "native load" obligations in the regulated environment) receive preferential transmission treatment? If so, how does this affect wholesale electric power competition? How and by whom should retail sales of bundled transmission services (i.e., retail sales of both energy and transmission services) and retail sales of unbundled transmission be regulated? If by more than one entity, how should regulation be coordinated? What should the state's role be in overseeing wholesale transmission reliability?

Answer:

Firms that are appointed (or that successfully bid) to provide default or provider of last resort service should be granted pro rata access to available transmission capacity, but not preferential access. The regulatory system must be structured in a way that allows competing suppliers to gain equal access to transmission services.

Retail sales of "bundled" energy and transmission services will be regulated by the state, but the charges for transmission will be a direct pass-through of the RTO transmission charges approved by FERC. The state should not interpose itself in the oversight of transmission, except to recommend upgrades and expansion of transmission facilities to enhance transmission system reliability.

6. To what extent did the state identify transmission constraints affecting access to out-of-state or in-state generation prior to the start of retail competition? Is the state capable of remedying these transmission constraints, or is federal jurisdiction necessary? How do the rationales for federal jurisdiction over electric power transmission siting compare to the reasons underlying federal jurisdiction over the siting of natural gas pipelines?

Answer:

The FERC-regulated RTOs are responsible for remedying transmission constraints and approving transmission line siting plans. While the state has an important role in advising and commenting on transmission issues, ultimate authority must be with the RTO and FERC.

7. How have state siting regulations for new generation and transmission facilities been affected by the onset of retail competition? Has new generation siting kept pace with demand growth in the state? If not, why not? Is federal jurisdiction necessary for siting of electric power generation facilities? Has the state actively monitored and reported the relationship between in-state capacity and peak demand in the state? What incentives do suppliers have to maintain adequate reserve capacity? What are the ways to value capacity in competitive markets? Is reserve sharing still important in competitive markets? Do other institutions/market processes provide a reasonable substitute for reserve sharing?

Answer:

One of the many benefits of retail competition is that suppliers and consumers are confronted with accurate price signals that evidence the need for new power generation facilities. With time-of-use meter facilities that can be provided by unregulated competitive suppliers, consumers can respond to these price signals through the implementation of conservation measures. Suppliers respond to these price signals through the development of additional generation and supply. State siting regulations must be sufficiently flexible to allow generators to respond quickly to these market signals through the construction of new power plants. Recognizing the lead time that necessarily exists between the onset of price signals and the delivery of power from new sources, suppliers can and should develop portfolios of supplies that are not solely dependent upon spot-priced power.

8. Since the start of retail competition, what has been the rate of generation plant outages (scheduled and unscheduled)? To what extent has the state monitored these outages and examined their causes?

Answer:

No response.

Other Issues

1. What measures has the state taken to make customer demand responsive to changes in available supply? Has the state provided utilities incentives to make customers more price responsive? Has the state moved away from average cost pricing? What effect have these measures had on demand and on demand elasticity?

Answer:

To maximize the benefits of demand response programs, customers should be encouraged to replace existing, antiquated meters with advanced meters that measure usage electronically on a real-time basis. Additionally, to achieve meaningful benefits of demand responsiveness programs, utility metering costs must be fully and completely unbundled from other retail costs. Alternate service providers will not be able to offer this advanced metering technology, if the embedded costs of existing utility meters remain bundled in customers' distribution rates. Customers can and should be encouraged to adjust their energy usage based upon energy prices that vary with the time of day. However, customers should not pay twice for metering costs.

2. Has the state provided mechanisms and incentives for owners of co-generation capacity to offer power during peak demand periods? Has the state identified, reported, and facilitated development of pumped storage facilities or other approaches to arbitraging between peak and off-peak wholesale electricity prices?

Answer:

In a properly deregulated environment, price signals will provide appropriate incentives for suppliers to build and operate peak period generation facilities. As noted above, the states should ensure that the siting process is streamlined in order to facilitate the siting and construction of such plants.

3. What issues have arisen under retail competition that have required cooperation or coordination with other states? What approach was taken to securing this cooperation or coordination? Are there other issues requiring cooperation that have not yet been addressed? Which of these issues are the most significant?

Answer:

Like many other suppliers, Shell Energy participates in retail competition programs in a number of states. It would be extremely helpful if the rules and procedures that apply to retail competition would be uniform, to the extent practicable, among the states that adopt retail competition programs. Specifically, there is little reason for states to maintain different protocols for supplier registration, customer enrollment and switching, billing, and information transfer. It would be efficient and beneficial for states to embrace and adopt standardized business practices in connection with retail competition programs. Moreover, the costs to suppliers competing in several states, to abide by differing rules in those states is a serious barrier to competition.

4. How prevalent is the use of distributed resources (e.g., distributed generation) within the state? What barriers do customers face to implementing distributed resources?

Answer:

Because most distributed generation facilities are interconnected with utility systems at the distribution level, jurisdiction over interconnection procedures resides with state authorities. Nevertheless, uniform interconnection requirements would facilitate the planning and development of distributed generation on a nationwide basis.

5. Which specific jurisdictional issues prevent state retail competition programs from being as successful as they might be?

Answer:

Each state's program is unique based upon political considerations and regulatory decisions that vary based upon a multiplicity of factors. Participants in the competitive retail market must customize their products and services, as well as their procedures and protocols, to meet the specific requirements of each state. Unfortunately, the investment that is required to satisfy the peculiarities of one state's program detracts from the cost savings and innovation that can be offered by a supplier to its customers. The competitive retail program in general would benefit from the development of a model that could be applied in every state. Uniformity of programs among the states would make retail competition more understandable for customers and would enable suppliers to focus their efforts on enhancing service to customers.

Additionally, states must take jurisdiction over the exercise of market power in state-regulated functions. Some states commissions have declined to review merger proposals involving utilities located within the state. Some state commissions also lack resources to

monitor and challenge potential anti-competitive impact of mergers or market power on the competitive wholesale generation and transmission markets -- negative impacts that directly impact retail programs through higher wholesale rates and lack of transmission access to certain wholesale markets. Indeed, FERC often undertakes a more searching review of a utility merger or marketpower issues when a state commission raises market power concerns.

Thus, because state commissions cannot regulate wholesale generation prices and transmission access and often decline to address market power issues at the wholesale level, FERC must analyze the issue in somewhat of a vacuum. In turn, retail suppliers can and do bring market power issues to FERC; however, FERC's focus is on the review of vertical and horizontal market power in the wholesale market, not the details of and specific impacts on retail programs.

6. Which specific technological developments are likely to substantially affect retail or wholesale competition in the electric power industry that may alter the manner in which states structure retail competition plans? Why? What time frame is associated with these developments?

Answer:

As is noted above, electronic transfer of meter information and electronic delivery of billing information are two technology developments that will facilitate the growth of retail competition. In order for these technologies to proceed on a broad scale, however, customers must have a real choice between the "bundled" services provided by the incumbent utility, on the one hand, and the "unbundled" services offered by competing marketers and suppliers, on the other hand. In order to facilitate the expansion of competitive and innovative service options, the costs of duplicative utility services must be fully unbundled from the rates of those customers that elect retail competition.

7. What are the lessons to be learned from the retail electricity competition efforts of other countries? Are there other formerly-regulated industries in the U.S. (e.g., natural gas) that allow customer choice and provide useful comparisons to retail electricity competition? If so, what are the relevant insights or lessons to be learned?

Answer:

Retail competition in the natural gas industry is an appropriate model for retail electric competition. Retail natural gas competition allows consumers to have access to multiple, non-affiliated natural gas suppliers. Suppliers and consumers also are allowed non-discriminatory access to the utility distribution system and the ability to contract directly with interstate pipelines or receive releases of pipeline and storage contracts from local utilities. Wholesale natural gas prices are governed by competitive forces. This same approach should occur in the electric industry, with consumers allowed to have access to multiple, non-affiliated generation suppliers and assets, with non-discriminatory access to the utility distribution system and to the transmission grid governed by an independent RTO.

Where the natural gas model has come up short, however, is in the availability of retail competition for residential and small commercial customers. The experience in a number of states demonstrate that as long as the incumbent utility retains the role of provider of last resort, it is difficult, if not impossible to achieve a meaningful level of market penetration. However, in Georgia, Atlanta Gas Light was required to assign all its customers to competitive providers and, in turn, vest the provider of last resort responsibility in a competitive provider. This has created a vibrant market with multiple suppliers vying for customers while removing incentives for the utility to block competitive because it remains in the business of supplying natural gas to firm load.

Accordingly, a key lesson to be learned from natural gas retail competition is that the utility should be removed as the provider of last resort. Replacing the utility will stimulate and facilitate competition for sales to all levels of customers, including the smallest customers.

CONCLUSION

Shell Energy appreciates the opportunity to present the foregoing comments.

Respectfully submitted,

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